Written Testimony of
Terrence A. Duffy, Chairman,
Chicago Mercantile Exchange Inc.
to the
Committee on Agriculture
U.S. House of Representatives

Re: Application for Contract Market Designation of EUREX U.S.

November 6, 2003

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Thank you Chairman Goodlatte, Chairman Moran, and members of the Committee. As Chairman of the Board of Directors, I appreciate the opportunity to testify on behalf of Chicago Mercantile Exchange Inc. Our innovations during the three decades since we invented financial futures have spawned a vibrant, dynamic and highly competitive industry for managing risk. Today, CME is the largest futures exchange in the United States and will soon be the largest clearing organization in the world for futures and options on futures. We are the only demutualized and publicly traded financial exchange in the United States. We are regulated by the Commodity Futures Trading Commission ("CFTC"); we also comply with the disclosure and transparency requirements applicable to public companies under the Federal securities laws and NYSE listing standards. Our corporate structure, governance standards, compensation practices, business model and market practices are all publicly disclosed.

We employ 1,200 persons directly in the U.S. and, together with the Chicago Board of Trade, we account for nearly 150,000 jobs in the Chicago metropolitan area. We offer extensive trading and clearing facilities for futures and options on futures in interest rates, stock indexes, foreign exchange, commodities and other derivatives. We offer these products for trading via both our open outcry and our GLOBEX® electronic trading platforms. Nearly one-half of all trading activity in our products is fully automated, reflecting the extraordinary compound annual growth rate of 112% in GLOBEX volume from 1997-2002. This growth has been achieved despite fierce competition with foreign and domestic futures, options and securities exchanges and the over-the-counter derivatives market.

Each day, the CME Clearing House facilitates the transfer of about $1.5 billion per day in settlement payments, and we manage $29.6 billion in collateral deposits. Earlier this year, CME entered into an important clearing services agreement with the Chicago Board of Trade that will save end users of our markets approximately $1.4 billion in performance bond collateral and provide more than $200 million in capital savings for our valued clearing member partners. All of these innovations and changes have strengthened our competitive position and ability to provide the most efficient risk management and asset allocation services to institutions, corporations and individuals around the globe.

I thank the Committee for recognizing the importance of this issue and for your willingness to promptly devote your time and attention to this matter. I want to begin by reiterating my praise for the Commodity Futures Trading Commission and Chairman Newsome. When I testified before the Subcommittee earlier this year, I stated:

> "In the judgment of the CME, the Commodity Futures Modernization Act of 2000 (CFMA) represents successful landmark legislation that materially and beneficially reformed some of the nation's most important financial markets. Our futures markets are substantially stronger and more vibrant today as the direct result of Congress' enactment of the CFMA and, equally importantly, the CFTC's judicious and deliberate implementation of those reforms. Innovation has been encouraged and made less costly and more rewarding. The time between conception of a new product or trading system and its implementation has gone from years to days. Today, the vast majority of CME's investment in innovation is for improvement and testing rather than paperwork and bureaucratic review."

Chicago Mercantile Exchange Inc. welcomes this opportunity to offer its view of the question of whether the application for contract market designation (the "Application")[1] filed by U.S. Futures Exchange, L.L.C. ("EUREX U.S."), Eurex's wholly owned U.S. subsidiary, is complete. I am here today because I believe Congress never intended to allow new exchanges to commence operations in the U.S. without explaining how they will regulate activity in their markets, how they will assure safe and sound clearing and settlement of transactions, why it is appropriate to offer tens of millions of dollars in rebates to fiduciary intermediaries to move order flow from an established liquid market to another new market and how U.S. authorities can affect the true controlling persons of exchanges that may be controlled by persons and organizations resident outside of the United States. The questions that I raise here today are not founded on objections to entry by a foreign competitor. At the end of the day, I hope to convince you and the Commission that these important issues have been camouflaged by an empty application that needs to be completed before final Commission action.

Overview

On September 16, 2003, Eurex's wholly owned U.S. subsidiary submitted its application for contract market designation and asked for approval within 60 days—without formal Commission review. The Commission announced that it intended to give Eurex fast track treatment, as requested. EUREX U.S.'s evident plan was to secure CFTC designation for its empty shell of an exchange, and thereafter to "self-certify" the rules that implement its true business plan in a manner that would escape Commission

[1] As used herein, the term "Application" includes all the publicly available exhibits that EUREX U.S. has submitted to the Commission in support of its application, unless the context requires otherwise. All terms capitalized herein and not otherwise defined shall have the meaning ascribed to them in EUREX U.S.'s Rules.

review and approval. This tactic precludes scrutiny from the Commission and other interested parties. We made a clear case that the fast track process was not appropriate, and the Commission responded appropriately.

EUREX U.S.'s application is an empty shell. It omits important facts concerning how it will handle critical regulatory, clearing, settlement and financial responsibilities and the contracts it will trade. These omissions were intentional. EUREX U.S. knows the answers; it is circulating marketing materials to selected market participants that define some of these processes. It omitted reference to its business plans because it did not want to defend these practices as a condition of contract market designation.

Novel and objectionable issues pervade Eurex's skeletal application. All of Eurex's critical clearing, operational and regulatory functions are outsourced to third parties, one of which, the parent company, is based in Germany and not subject to the Act, and another, NFA, is not authorized or qualified to perform the required functions. Eurex intends to offer an internationally linked clearing system that permits customers to transfer positions between Germany and the United States. Such arrangements also present significant potential cross-border bankruptcy and other legal risks which have not been clearly delineated for market users and regulators. EUREX U.S.'s application purposefully omits reference to any of these planned business and operational practices. We believe that this Application should be remitted to Eurex for completion prior to any further consideration by the Commission.

EUREX U.S.'s Proposal is Materially Deficient

EUREX U.S.'s Application consists of 20 documents. The documents that are key to understanding whether EUREX U.S. satisfies the criteria for designation were labeled confidential by it and are not being released for pubic comment.[2] The suppressed documents deal with the most basic aspects of the operation and regulation of the proposed exchange, including the agreements that govern EUREX U.S.'s proposed clearing, performance and regulatory arrangements and capabilities—in other words, the heart of EUREX U.S.'s proposal.

An applicant may not demand confidential treatment for an entire document that includes a few snippets of confidential information that may easily be redacted. EUREX U.S. failed to justify its demand for confidential treatment with the required "reasonable justification." This is clearly demonstrated by the abrupt about-face on a number of the documents shortly after CME's September 16, 2003, Freedom of Information Act ("FOIA") request to release those documents.

[2] The only documents that have been released to the public are: 1) a chart prepared by EUREX U.S. that purports to demonstrate compliance with the Commission's Core Principles (the "Chart"); 2) EUREX U.S.'s Certificate of Formation; 3) EUREX U.S.'s Limited Liability Agreement and Bylaws (the "Bylaws"); 4) EUREX U.S.'s Exchange Rules (the "Rules"); and 5) membership applications and systems-related manuals.

As explained in greater detail below, the applicant has not offered any information to demonstrate that its complete delegation of regulatory functions satisfies either Designation Criterion 2 or 3. An application that merely states that NFA and/or Eurex will perform such functions without any descriptions of the specific resources that they will bring to bear, their experience and their skill, does not fulfill the designation criteria.

CME believes that having the opportunity to review all the documentation relating to the Application is critical to allowing CME and other interested parties to make an informed assessment of EUREX U.S.'s proposal. CME also believes that EUREX U.S. is required to make the information public, pursuant to Designation Criterion 7 of the Act[3] and Core Principle 7 of the Act,[4] both of which are designed to ensure that the public has broad access to a proposed exchange's rules and regulations. To date, however, CME has not received the core information upon which the Application rests. At a minimum, we urge the Commission to require EUREX U.S. to supplement or amend the Application to fill in the gaping holes and request the Commission to provide commentators another opportunity to submit comments after the documentation is made available to the public.

The Application Does Not Demonstrate Compliance With The Act

The Application is materially inconsistent with the Act, in that it is replete with deficiencies and inconsistencies, and raises important questions concerning Commission policy that must be answered before EUREX U.S. is licensed for business in this country. For the reasons discussed below, the Commission should not approve the Application.

Improper Payment For Order Flow Practices.

In a EUREX U.S. report entitled "Global Access to the World's Benchmark Derivatives," dated September 2003 (the "Report"), EUREX U.S. announced its intention to "Promote Liquidity Through [a] Public Market Making Scheme."[5] The scheme includes a payment for order flow program, in which EUREX U.S. seeks to entice its brokers to direct customer business to EUREX U.S. by offering a chance at a large pay off. The Report provides that a "revenue rebate plan for the US Treasury derivative products will run for the first two years of Eurex US operations[,]" providing

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[3] Designation Criterion 7 of the Act provides that: "The board of trade shall provide the public with access to the rules, regulations, and contract specifications of the board of trade."

[4] Core Principle 7 of the Act provides that: "The board of trade shall make available to market authorities, market participants, and the public information concerning—(A) the terms and conditions of the contracts of the contract market; and (B) the mechanisms for executing transactions on or through the facilities of the contract market."

[5] *See* Report at 9. The relevant pages of the Report are attached as Exhibit A.

"50% of trading fee revenues on the first year of operation [and] 25% of trading fee revenues on the second year of operation."[6] Notably, "[r]evenue will be refunded on a monthly basis to Top 10 firms in agency and Top 10 in prop/market making activity, in proportion to their volume."[7]

EUREX U.S.'s proposed plan to buy order flow is improper and unprecedented in the U.S. futures markets. While the Commission has not previously considered payment for order flow programs, the Securities and Exchange Commission (the "SEC") and its staff have long been critical of such programs. For example, in January 2003, former SEC Chairman Harvey Pitt sent a letter to the five U.S. options exchanges, urging them voluntarily to abolish exchange-sponsored plans that encourage payment for order flow (and internalization). In the letter to the exchanges, Chairman Pitt stated: "I am seriously concerned that economic inducements to order-flow providers and internalization by member firms create serious conflicts of interest that can compromise a broker's fiduciary obligation to achieve best execution of its customer orders."[8]

We believe that the Commission should not permit payment for order flow programs to infiltrate the U.S. futures markets. Most importantly, payment for order flow programs are inconsistent with a broker's duty to its customers. Brokers in the U.S. futures markets owe a fiduciary duty to their customers but are not subject to a best execution rule. That duty would be violated if brokers were entitled to very large payments from EUREX U.S. if they won the monthly contest for sending customer orders to that market. No amount of boilerplate disclosure can cure that form of breach of fiduciary duty. Moreover, if permitted in the U.S. futures markets, such programs would likely weaken the self-regulatory functions of the exchanges administering these programs, because it puts the exchange in the position of undue involvement in the

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6 *Id*. at 10.

7 *Id*.

8 Letter from Harvey Pitt, Chairman, SEC, to Meyer Frucher, Chairman, Philadelphia Stock Exchange ("Phlx"), (January 24, 2003); *see also,* SEC Chairman Arthur Levitt, "Toward Markets Driven By Footsteps," Remarks at 67th Annual Conference and Business Meeting of Security Traders Association (October 12, 2000); SEC Special Study: Payment for Order Flow and Internalization in the Options Markets (December 2000).

Moreover, in response to Chairman Pitt's letter, the Phlx moved to challenge payment for order flow and internalization practices. On February 4, 2003, the Phlx submitted a petition to the SEC, formally requesting the SEC to ban exchange-sponsored payment for order flow programs. In its rulemaking petition, the Phlx stated that it "strongly agree[s] with Chairman Pitt that exchange-sponsored payment for order flow programs are deleterious to the options markets," and that the practice has "put unfair burdens on market makers and place exchanges . . . in the uncomfortable position of administering payment arrangements between specialists and order flow providers." *See* Phlx Petition for Rulemaking, Options Exchange Payment for Order Flow Programs (February 3, 2003). To date, the SEC has not acted on the Phlx's petition.

details of payment for order flow mechanics, when the exchange should be focused on ensuring that such arrangements do not compromise the responsibilities of market makers to their customers.

As proposed, EUREX U.S.'s program is a bold implementation of the worst form of payment for order flow, because EUREX U.S. is not only prepared to buy order flow (rather than compete for it), but has created a "scheme" with respect to U.S. Treasury futures in which only the top 10 firms will receive rebates—an artifice that will encourage brokers to blindly funnel customer orders to EUREX U.S. in hopes of scoring a large rebate. In promoting the interests of brokers, EUREX U.S.'s program relegates the interests of customers to an afterthought. (Indeed, nowhere in the 28-page Report is the term "customer" even mentioned.)

The Application, premised upon the payment for order flow program, is inconsistent with the Act. Moreover, to the extent that EUREX U.S. desires to implement a payment for order flow program, the Commission should publish any such proposal in the *Federal Register* and provide for a public comment period in which interested parties are afforded the opportunity to submit their opinions of the controversial practice.[9]

Market Surveillance Concerns and Deficiencies

EUREX U.S. has stated that its compliance and surveillance functions will be performed under a regulatory services agreement with the NFA (an agreement that EUREX U.S. has asked the Commission to keep confidential). NFA's Board of Directors has not yet been presented with nor considered the agreement.

We know that the agreement calls for NFA to administer and enforce EUREX U.S's trade practice and anti-manipulation rules. NFA's Articles of Incorporation preclude it from performing such services for a designated contract market. Article III, Section 2(a) sets forth certain activities that are prohibited, such as the following: "No NFA requirement shall purport to govern or otherwise regulate the specific conduct of a Member or Associate if such conduct is governed or regulated by the requirements of a contract market…" Section 2(b) further provides that:

> (b) Prohibition Upon Adoption of Certain Rules.
>
> NFA shall not adopt, *administer or enforce* upon any Member or Associate a rule, standard, requirement or procedure which purports to govern or otherwise regulate any of the following:
> **********

[9] In 2000, the SEC published and provided a public comment period with respect to the International Stock Exchange's proposal to adopt a payment for order flow fee program. *See* Securities Exchange Act Release No. 43462 (October 19, 2000).

(iii) The rights, privileges, duties or responsibilities of membership in any contract market or clearing organization.
(iv) The content, interpretation, administration or enforcement of any rule, standard, requirement or procedure of a contract market or clearing organization.
(v) The conduct of business or other activities on the trading floor of a contract market.
(vi) The terms or conditions of any futures contract.(emphasis supplied)

NFA's organizing documents reinforce the conclusion that the Eurex Regulatory Service Agreement exceeds the purposes of NFA. For example, the meeting minutes of NFA's Organizing Committee, dated October 12, 1976, note that compliance and surveillance activities "[s]hould not reach floor brokers or Exchange activities." Further, in a letter to the Acting General Counsel of the Commodity Futures Trading Commission ("CFTC"), dated February 24, 1977, counsel for NFA assured the CFTC that "[i]t is not the intention or objective of the Organizing Committee to shift any of [the duties imposed on contract markets by Section 5 and 5a of the Commodity Exchange Act] from the contract markets to NFA. On the contrary, great care has been exercised to assure that section 5 and section 5a responsibilities remain with the exchanges. An examination of the initial functions to be performed by the NFA shows that no mandatory duty of a contract market is involved."

Further, in its Points of Agreement contained in its Handbook of 1977, NFA agreed that it "should regulate in all respects the industry segments not subject to exchange regulation…." The intent of the Organizing Committee was to "close any existing regulatory gaps that exist with respect to persons and entities that are not subject to exchange self-regulation" not overlap or pre-empt exchange rules. However, the Organizing Committee did not preclude regulation of the exchanges at some future point in time. Instead, the Points of Agreement state that while "NFA will not undertake initially any other regulatory function affecting activities of persons or entities on contract markets [the Articles may] be subject to amendment so that new and different functions can be assumed by the NFA in the future when there is clear support for doing so…."

However, no such amendment has been implemented by the Board. Currently, the plain language of Article III prohibits NFA from performing the services contemplated by the contract with EUREX U.S. In NFA's 1979 brochure, it clearly states that "NFA will not regulate any matters within the exchanges' special expertise, such as floor practices, contract terms, margin requirements, market surveillance, the rights or obligations of floor brokers, and capital requirements for clearing privileges." In addition, in a letter signed by Leo Melamed containing NFA's comments to the CFTC, dated November 6, 1978, Mr. Melamed stated that "the contract markets are not proposed for membership in the NFA as a means of policing the exchanges" nor to oversee the exchanges. In its Registration Statement dated March 16, 1981, it states that "[i]n accordance with NFA's policy of not regulating contract market matters, NFA will not bring disciplinary actions against a person where the specific conduct in question is covered by a contract market rule and the person is subject to the contract market's disciplinary jurisdiction for the conduct."

At a hearing before the CFTC on June 4, 1981, Mr. Melamed testified that NFA's purpose is "not to regulate the order flow once it hits the floor of an exchange but rather to regulate all that occurred before it does in fact. The dividing point becomes right there. It is the exchanges that take over at that point, the NFA previous to that." Mr. Melamed further testified that "it has always been our intention not to get involved with the floor brokers, or regulation, or rules of and for that community of members. The exchanges have done a thorough job in this area, and have an intricate set of rules, and a long history of regulation over floor brokers and the community on the floor, it is not the intention of NFA to ever overstep that divisional line, and we will not." Clearly, providing the services described in the proposed contract with EUREX U.S. at this time would violate NFA's Articles.

NFA's Executive Committee's response to this explanation does not even come close to passing the "red face test." In its revelatory, self-justifying letter to the Commission, NFA first admits that: "NFA will conduct trade practice and market surveillance (TPMS) on behalf of Eurex U.S." NFA boasts that it has absolute power to control its investigations. It goes on to explain that, as the appointed agent of EUREX U.S., NFA will have power to compel members to produce documents and to cooperate with its investigations. It concedes that NFA will prosecute alleged violations. But NFA contends that its actions do not constitute "administration or enforcement" of the disciplinary rules because: "NFA is merely a contractual service provider and will not make any decisions on behalf of Eurex U.S. NFA will investigate potential rule violations and will make its enforcement attorneys available to prosecute enforcement cases on an hourly basis, just as any hired law firm would do, but Eurex U.S. will determine whether to initiate a formal investigation, whether to issue a complaint, and how to resolve a charged matter." ***If NFA is not administering and enforcing the rules, no one is.*** EUREX U.S. does not even have its own disciplinary committees. The fact that NFA provides the services "under contract" does not change the nature of the services. NFA's agreement is *ultra vires.*

In addition to its lack of corporate authority, NFA lacks the resources and experience to perform the required regulatory services. EUREX U.S.'s business plan is to link its trading and clearing with its parent, Eurex Deutschland. Linked trading and clearing requires a single surveillance and compliance system or closely coordinated separate systems that seamlessly integrate the information from both trading and clearing systems. Otherwise, inexplicable changes in open interest, manipulative wash trades, and any number of abusive trading practices that affects EUREX U.S. and other U.S. futures markets can be executed and cleared on the facilities of Eurex and be beyond the regulatory reach of NFA. NFA has not demonstrated that it has the capacity to regulate effectively and prevent market manipulation in the international context.

Even if EUREX U.S.'s business plan did not create these intractable problems – if EUREX U.S. were merely a stand-alone U.S. exchange – NFA does not have the human resources to perform the outsourced regulatory services at the level required by the CEA's Core Principles. NFA has implied that its staff includes a sufficient number of

well-trained investigators and analysts to service EUREX U.S.'s regulatory needs. NFA's trade practice market surveillance area ("TPMS") consists of two full-time staff and a manager who has other responsibilities in addition to TPMS. These people are already working on other outsourcing projects and are hard-pressed to do an adequate job on the small projects to which they are already assigned. Indeed, with respect to a recent Commission Rule Enforcement Review of the BrokerTec Futures Exchange ("BTEX"), the Commission found that, "in reviewing BTEX's program for enforcing its block trading and exchange of futures for physicals ("EFP") rules, NFA did not examine an adequate number of block trades or EFPs to ensure compliance with BTEX rules."10

NFA claims to have six individuals cross-trained and ready to go to work in these areas. However, four of those individuals are auditors who have never done trade practice or market surveillance work and who appear to be fully employed. NFA has no dedicated IT resources within TPMS, and its computer hardware and tools are limited. Without skilled, experienced regulatory staff, NFA cannot possibly be an effective regulatory resource as required by the Act.

NFA's plan to perform trade practice surveillance for EUREX U.S. depends on the use of its automated system. NFA's plan assumes that all or substantially all of EUREX U.S.'s trading will be executed on its electronic system and that NFA will be able to base its review on trustworthy, electronically generated trade data. It does not appear that NFA has understood or accounted for the manner in which Eurex will conduct its option trading. The CBOT's comment letter on EUREX U.S.'s application makes it clear that the options on futures market is conducted by means of a call around market that does not leave an indelible, accurate audit trail.

By comparison, at least with respect to futures options trading, Eurex Deutschland relies primarily on a "call-around" market, resulting in "OTC" trading of a vast majority of such options transactions, though the exchange's alternative execution facilities. Therefore, Eurex Deutschland's options markets are quite different from the transparent options markets that have historically protected U.S. market participants. More specifically, those transactions that are executed through the alternative execution facilities (OTC transactions) are the primary driving force behind options volume on Eurex Deutschland as highlighted below:

Volume figures for 2003 (January-August)

Euro Schatz:	Futures 77,637,697 (Basis Trades 1,797,378, 2.3%)
	Options 8,766,545 (OTC 8,561,349, 97.7%)
Euro Bobl:	Futures 102,006,518 (Basis Trades 4,363,548, 4.2%)
	Options 6,869,541 (OTC 6,594,179, 96%)
Euro Bund:	Futures 169,704,106 (Basis Trades 6,746,675, 3.98%)
	Options 20,163,112 (OTC 16,898,721, 83.8%)

(Source: Eurex August 2003 Monthly Statistics)

[10] *See* Press Release No. 4847-03, CFTC, Rule Enforcement Review of the BrokerTec Futures Exchange (Oct. 2, 2003).

NFA has no means to monitor those OTC transactions for compliance with EUREX U.S.'s rules.

Avoidance of Treasury Department Review

The application is so devoid of information it fails even to specify the contracts that will be traded, although EUREX U.S. is telling its prospective customers, that a full suite of U.S. Treasury products will be listed on February 4, 2003. This omission from the application appears to be an effort to exploit an apparent loophole in the CEA and avoid Treasury Department scrutiny of its planned Treasury Security Futures contracts.

The Commodity Exchange Act requires the CFTC to give Treasury and other interested agencies and departments an opportunity to comment on certain futures contracts. CEA Section 2(a)(8)(b)(ii) provides in relevant part:

> "(ii) When a board of trade applies for designation or registration as a contract market or derivatives transaction execution facility involving transactions for future delivery of any security issued or guaranteed by the United States or any agency thereof, the Commission shall promptly deliver a copy of such application to the Department of the Treasury and the Board of Governors of the Federal Reserve System. The Commission may not designate or register a board of trade as a contract market or derivatives transaction execution facility based on such application until forty-five days after the date the Commission delivers the application to such agencies or until the Commission receives comments from each of such agencies on the application, whichever period is shorter. . . . [T]he Commission shall take into consideration all comments it receives from the Department of the Treasury and the Board of Governors of the Federal Reserve System and shall consider the effect that any such designation, registration, suspension, revocation, or action may have on the debt financing requirements of the United States Government and the continued efficiency and integrity of the underlying market for government securities."

This provision was added by the Futures Trading Act of 1978. The stated purpose was to insure that the Treasury Department had a fair chance to assess the impact of the new market on "the debt financing requirements of the United States Government and the continued efficiency and integrity of the underlying market for government securities." (Senate Report No. 95-850, May 15, 1978, Letter from The Deputy Secretary of the Treasury, Robert Carswell, to the Honorable Patrick J. Leahy (April 13, 1978) at 46.) The legislative history of this section demonstrates the importance with which the Treasury Department and the administration regarded this provision.

Section 2(a)(8)(b)(ii) was amended by the Commodity Futures Modernization Act of 2000 (Appendix E of P.L.106-554, 114 Stat. 2763) by adding "or derivatives transaction execution facility" after "contract market." CFMA also changed the process that a designated contract market was required to follow in order to list new futures

contracts. CFMA permits an existing designated contract market to list a new contract based on Treasury Securities by providing to the Commission and the Secretary of the Treasury a written certification that the new contract complies with this chapter. Self certification under this provision may create an opportunity to obviate Treasury's power to review and comment as provided in Section 2(a). Section 5c provides in relevant part:

> Sec. 5c. COMMON PROVISIONS APPLICABLE TO REGISTERED ENTITIES
> (c) NEW CONTRACTS, NEW RULES, AND RULE AMENDMENTS.-
> (1) IN GENERAL. - Subject to paragraph (2), a registered entity may elect to list for trading or accept for clearing any new contract or other instrument, or may elect to approve and implement any new rule or rule amendment, by providing to the Commission (and the Secretary of the Treasury, in the case of a contract of sale of a government security for future delivery (or option on such a contract) or a rule or rule amendment specifically related to such a contract) a written certification that the new contract or instrument or clearing of the new contract or instrument, new rule, or rule amendment complies with this chapter (including regulations under this chapter).

This addition made by CFMA creates an apparent loophole that permits a new exchange, intent upon trading Treasury Security futures, to avoid scrutiny from the Treasury. The legislative history of this provision does not explain whether the general provisions of Section 5c were intended to supersede the specific provisions of Section 2(a)(8)(b)(ii), which was amended and preserved by the same Act. We have reviewed the relevant committee reports and testimony and have not found an explanation. It is possible to reconcile the two provisions if the requirement that a registered entity certify that the new contract "complies with this chapter" means that a new contract based on a Treasury Security was submitted to the Treasury Department for review in accordance with Section 2.

EUREX U.S. intends to avoid Section 2(a)(8)(b)(ii) and exploit this lacuna by proceeding with a designation application that includes no information respecting the contracts it intends to trade. EUREX U.S.'s application omits specifications for the Treasury Security Contracts it intends to trade: yet it knows and has told all of its potential customers that on February 1, 2004 it will list the full suite of U.S. Treasury Securities. EUREX U.S. has also told its prospective customers that it intends to permit the resulting Treasury Security futures contracts to be sent to Germany for clearing by an unregulated entity.

There are two ways to prevent this obvious misuse of the CFMA. First and most directly, the CFTC, after consultation with Treasury, could reject the application as incomplete and require that EUREX U.S. resubmit with full disclosure of: the contracts it intends to trade; its arrangements for international trading linkages; the means by which it intends to provide domestic clearing for those contracts; and the international clearing linkages that it intends to implement. If the CFTC requires a complete application, it will be required to submit all Treasury related security futures contracts to the Treasury Department for review and comment under Section 2(a)(8)(b)(ii).

Second, the CFTC could be asked to commit to condition any contract market approval on a requirement that EUREX U.S. refrain from self-certifying any futures contract based on any Treasury Security without following all of the procedures set forth in Section 2.

Important Matters Not Addressed in the Rules

We have separately provided the Commission with our preliminary analysis of the defects in EUREX U.S.'s proposed Rules. In addition to those defects, however, the proposed Rules fail to address several trade practice-related matters that are vital to the integrity of the futures markets. For example:

- The Rules do not specifically require the entry of customer orders in the order of receipt, in violation of Designation Criterion 3 of the Act and Core Principle 12 of the Act;
- The Rules do not specifically prohibit the disclosure of orders prior to execution, in violation of Designation Criterion 3 of the Act and Core Principle 12 of the Act;
- The Rules do not specifically prohibit the withholding of(?) orders from the market, in violation of Designation Criterion 3 of the Act and Core Principle 12 of the Act; and
- The Rules do not adequately establish fitness standards for *all* persons that may have direct access to the Trading Facility, in violation of Core Principle 14 of the Act.[11]

Clearing and Risk Management Deficiencies

A clearing and settlement system requires logical, comprehensive and detailed procedures. As discussed more fully below, the Rules fail to spell out how many of the procedures would be performed, in contravention of Designation Criterion 5 of the Act.[12]

The Proposed Clearing Arrangement

It appears from public statements made by Eurex U.S. and The Clearing Corporation (the "CC") that CC has agreed to provide clearing and settlement services.

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[11] Core Principle 14 provides that: "The board of trade shall establish and enforce appropriate fitness standards for directors, members of any disciplinary committee, members of the contract market, and any other persons with direct access to the facility (including any parties affiliated with any of the persons described in this paragraph)."

[12] Designation Criterion 5 of the Act provides, in part, that: "The board of trade shall establish and enforce rules and procedures for ensuring the financial integrity of transactions entered into by or through the facilities of the contract market, including the clearance and settlement of the transactions with a derivatives clearing organization."

The alleged agreement has been submitted to the CFTC but has not been made available to the public, despite requests by CME. CFTC's refusal to provide the requested agreement is particularly objectionable given the fact that CME and CBOT immediately granted permission to the Commission to release our Clearing Services Agreement upon receiving a request from the Futures Industry Association. Accordingly, the Application is premature for consideration by the Commission.

Moreover, we note that a significant aspect of the proposed clearing arrangement does not appear to satisfy Designation Criterion 5 of the Act and Core Principle 11 of the Act,[13] each of which require that transactions executed on a designated contract market be cleared and settled through a registered derivatives clearing organization ("DCO"). According to the representations of Eurex Frankfurt, Eurex Frankfurt and Eurex U.S. intend to develop a "transatlantic marketplace" through a "global clearing solution" involving both Eurex Clearing AG ("Eurex Clearing") and the CC.[14] With respect to the fungible Euro-denominated products that Eurex U.S. intends to offer, the arrangement would appear to allow members of Eurex U.S. or Eurex Clearing to choose to clear their respective Eurex U.S. or Eurex Frankfurt trades either through the CC or Eurex Frankfurt. However, because the proposed arrangement contemplates that trades executed on Eurex U.S. may be cleared at Eurex Clearing by a Eurex Frankfurt clearing member, the Act requires Eurex Clearing to obtain designation as a DCO. To our knowledge, Eurex Clearing has not obtained such a designation. As a result, a fundamental aspect of Eurex U.S.'s clearing proposal does not conform to the Act.

Deficient Risk Management Rules

Several of EUREX U.S.'s rules do not adequately ensure the financial integrity of transactions entered through the proposed Trading System. They include:

(a) EUREX U.S. Rules 302 and 307—Minimum Financial Standards.

Rather than provide specificity, the Rules vaguely sketch the minimum financial requirements for Members. For example, Rule 302(iv) states that "the applicant shall have adequate financial resources and credit." Rule 307(l) mentions that Members are required to maintain their financial resources at or in excess of the amount prescribed by EUREX U.S. Notably, however, the Rules do not refer to or incorporate the specific requirements of CFTC Rule 1.17, which sets forth detailed minimum financial standards. At the same time, the Rules do not appear to specify any requirements for non-registered clearing firms.

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[13] Core Principle 11 of the Act provides that: "The board of trade shall establish and enforce rules providing for the financial integrity of any contracts traded on the contract market (including the clearance and settlement of the transactions with a derivatives clearing organization). . . ."

[14] *See e.g., Id.*; Press Conference, Eurex Frankfurt, *New Opportunities for Derivatives Trading and Clearing* (September 16, 2003); Press Release, Eurex Frankfurt, *Partnership Deal signed between The Clearing Corporation and Eurex* (September 4, 2003).

(b) EUREX U.S. Rule 307— Protection of Customer Funds.

While Rule 307(b)(x) requires Members and Clearing Members to notify EUREX U.S. if they fail to maintain segregated funds as required by the Commission, the Rules do not provide any guidance as to the types of funds that may or may not be segregated. Moreover, the Rules do not refer to or incorporate the specific CFTC rules that apply to the protection of customer funds. CFTC Rules 1.20 through 1.30 and 1.32 provide specific requirements for the protection of customer funds, namely, the timely and accurate calculation of funds in segregation, maintenance of sufficient funds in segregation and the appropriate establishment of customer-regulated accounts. The EUREX U.S. Rules do not provide its Members with any guidance in this area.

(c) EUREX U.S. Rule 506—Margins.

Rule 506 purports to set forth the Members' obligations with respect to margin, but the rule is silent with respect to acceptable collateral and margin policies. The Rules only address the amount of margin to be collected by Members from its customers. In addition, while the Rules provide that the Members "must collect from its customers additional margin in an amount and at such time as EUREX U.S. may from time to time determine," they do not provide any guidance on the factors that may be considered by EUREX U.S. in requiring additional margin. In addition, there is no guidance on when margin calls will or should be made, what types of collateral can be deposited by customers to satisfy margin calls, under what conditions new orders may be accepted, when funds may be disbursed, when positions must be liquidated and the consequences of not maintaining sufficient margin. Such important guidance appears absent from EUREX U.S.'s Application.

(d) Member Defaults.

Except for a brief reference to Member defaults in EUREX U.S.'s membership application, the Rules fail to set forth the appropriate treatment of customer collateral and the actions, if any, that a defaulting Member must take to transfer positions to a non-defaulting Member.

Recordkeeping Deficiencies.

In an effort to prevent customer and market abuses, the Act requires exchanges to establish and enforce strict recordkeeping requirements.[15] The Application, however, is rife with recordkeeping deficiencies. For example:

1. EUREX U.S. Rule 307(d)—Commission Recordkeeping Requirements.

Core Principle 10 of the Act imposes requirements upon DCMs with respect to the "recording and safe storage of all identifying trade information." However, in vaguely mentioning that Members must maintain records "showing the details and terms of all transactions in all Contracts," Rule 307(d) fails to specify the types of records that Members are required to maintain. The failure to specify such records is likely to hamper EUREX U.S.'s ability to use such information to prevent and detect customer and market abuses.

2. EUREX U.S. Rule 307(j)—Contracts Entered Under ID.

Rule 307(j) and its companion rules set forth unsatisfactory minimal audit trail requirements. Most importantly, the Rules do not appear to require terminal operators to enter an ID or an account number into the Trading System prior to entering an order.[16] Without such basic information, EUREX U.S. cannot adequately conduct audit trail analyses to decipher improper conduct.

3. EUREX U.S. Rule 307(n)—Priority of Customer Order Entry.

Rule 307(n) attempts to prescribe the priority of customer orders, but contains a major gap. The rule appears to allow a Member that receives a customer order to ask or instruct a terminal operator to enter a third-party order into the Trading System, provided that neither the terminal operator nor the third-party are aware of the customer order. The rule thus permits the potential withholding and front-running of customer orders.

Operational Concerns.

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[15] *See* Core Principle 10 of the Act, which provides that: "The board of trade shall maintain rules and procedures to provide for the recording and safe storage of all identifying trade information in a manner that enables the contract market to use the information for purposes of assisting in the prevention of customer and market abuses and providing evidence of any violations of the rules of the contract market."

[16] To the extent that such information is buried in EUREX U.S.'s systems manuals, we believe that such important information should be part of the Rules promulgated by EUREX U.S.

According to the Application and press reports, EUREX U.S. is seeking to outsource a significant portion of its operation of the proposed exchange to foreign-based entities (*i.e.*, Eurex and Deutsche Börse AG). Specifically, EUREX U.S. has allegedly entered into two outsourcing agreements: 1) a General Services Agreement with Eurex; and 2) a Service Level Agreement between Deutsche Börse AG and Eurex. Neither of these documents has been made public. Given the significance of the alleged outsourcing, it is untenable that these documents have not been made public. Accordingly, the Exchange reiterates its request that the proposed outsourcing agreements be made public and commentators be given an opportunity to provide comments.

Moreover, Section 5c(b) of the Act provides that an exchange "may comply with any applicable core principle through delegation of any relevant function." However, the section further requires that the delegation occur to a "registered futures association or another registered entity." Deutsche Börse AG and Eurex do not satisfy this requirement, thus making the Application fatally flawed.

Conclusion

If approved, Eurex will become a designated "black box" market whose critical regulatory, operational and clearing functions are outsourced to third parties, unknown to the CFTC and the industry and potentially outside the jurisdictional reach of the Commission when the time comes to act. There is no reason to delay approval of complete and sound applications of new exchanges. There is every reason to ensure a proper process is followed for new exchanges that will offer products and services to U.S. investors.

We urge that the Commission disapprove the proposal as filed. At a minimum, EUREX U.S. should be required to supplement or amend the filing to fill in the gaping holes, and commentators should be given another opportunity to submit comments.